

# 19

## Deducting Miscellaneous Expenses

Deductible miscellaneous expenses cover a wide and varied range of items, such as employee travel and entertainment expenses, work clothes expenses, union and employee professional dues, investment expenses, legal expenses, tax preparation expenses, and educational expenses. They also share a common limitation: the 2% adjusted gross income (AGI) floor. If your expenses do not exceed this floor, you may not deduct them. If the expenses exceed the floor, only the excess is deductible on Schedule A, as explained in ¶19.1. Some job-related deductions, such as moving expenses and impairment-related work expenses, are not subject to the 2% AGI floor.

In addition to the 2% AGI floor, employees who incur unreimbursed meal and entertainment costs face this further restriction: Only 50% of meal and entertainment costs are deductible.

Miscellaneous deductions, except for gambling losses, are subject to the 3% reduction to itemized deductions (¶13.8) if your adjusted gross income exceeds \$117,950 (\$58,975 if you are married and file separate returns).

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See ¶

## Miscellaneous Expenses

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## ¶19.1 2% AGI Floor Reduces Miscellaneous Deductions

A floor of 2% of adjusted gross income (AGI) applies to the total of most miscellaneous deductions that are claimed on Schedule A of Form 1040. AGI is the amount on Line 32 of Form 1040; also *see* ¶13.7. The purpose of the floor is to reduce or eliminate such deductions. Only expenses above the floor are deductible.

If your 1996 AGI exceeds \$117,950, or \$58,975 if married filing separately, deductible miscellaneous expenses (after applying the 2% AGI floor) are then subject to a further reduction under the 3% reduction computation discussed at ¶13.8.

### *Miscellaneous expenses subject to the 2% AGI floor:*

- Unreimbursed travel, meals, and entertainment expenses of employees, ¶20.1 and ¶20.31
- Reimbursed job expenses or expense allowances under nonaccountable plans, ¶20.32
- Union dues, ¶19.5
- Professional and business association dues, ¶19.5
- Work clothes expenses, ¶19.6
- Cost of looking for a new job, ¶19.7
- Job agency fees, ¶19.7
- Tax advice and preparation fees, ¶19.25
- Appraisal fees related to casualty losses and charitable property contributions, ¶19.25
- Investment expenses, such as IRA custodial fees, safe deposit rentals, and fees to investment counselors, ¶19.24
- Employee home office expenses, ¶19.13
- Legal fees, ¶19.26
- Education costs, ¶19.15

### *Miscellaneous expenses not subject to the 2% AGI floor:*

- Moving expenses to a new job location, Chapter 21
- Impairment-related work expenses for handicapped employees, ¶19.4
- Gambling losses up to gambling income, ¶12.3
- Estate tax attributable to income in respect of a decedent, ¶11.4
- The deduction for repayment of amounts held under a claim of right, ¶2.9

- Amortizable bond premium on bonds purchased before October 23, 1986, ¶4.17
- Unrecovered investments in pension on deceased retiree's final return, ¶7.22
- Jury duty fees turned over to employer, ¶19.4

## EXAMPLES

1. You pay union dues of \$280, work clothes costs of \$300, and \$150 for the preparation of your tax return. Your adjusted gross income (AGI) is \$25,000. Your miscellaneous deduction on Schedule A after applying the 2% floor is \$230:

|                      |              |
|----------------------|--------------|
| Union dues           | \$280        |
| Work clothes         | 300          |
| Tax preparation      | 150          |
|                      | <u>\$730</u> |
| Less: 2% of \$25,000 | 500          |
| Deductible amount    | <u>\$230</u> |

2. Your adjusted gross income (AGI) is \$90,000. You pay the following deductible miscellaneous expenses:

|                              |                |
|------------------------------|----------------|
| Professional dues            | \$ 100         |
| Investment counsel fee       | 300            |
| Safe deposit box             | 50             |
| Tax preparation fee          | 500            |
| Unreimbursed travel expenses | 800            |
|                              | <u>\$1,750</u> |

Since the 2% floor of \$1,800 ( $2\% \times \$90,000$ ) exceeds your miscellaneous expenses, none of the expenses is deductible.

## ¶19.2 Effect of 2% AGI Floor on Deductions

The table below shows the effect of the 2% AGI floor on miscellaneous deductible expenses. A higher bracket taxpayer may also be subject to the 3% reduction to itemized deductions discussed at ¶13.8.

| <i>If your adjusted gross income (AGI) is—</i> | <i>Miscellaneous expenses must exceed this amount for a deduction—</i> |
|------------------------------------------------|------------------------------------------------------------------------|
| \$ 10,000                                      | \$ 200                                                                 |
| 20,000                                         | 400                                                                    |
| 30,000                                         | 600                                                                    |
| 40,000                                         | 800                                                                    |
| 50,000                                         | 1,000                                                                  |
| 60,000                                         | 1,200                                                                  |
| 70,000                                         | 1,400                                                                  |
| 80,000                                         | 1,600                                                                  |
| 90,000                                         | 1,800                                                                  |
| 100,000                                        | 2,000                                                                  |
| 200,000                                        | 4,000                                                                  |

## ¶19.3 Checklist of Job Expenses Subject to the 2% AGI Floor

The following expenses that are job related—ranging from professional dues and subscriptions to employment agency fees—are subject to the 2% AGI floor. Generally, you must file Form 2106 to claim job-related expenses that were not reimbursed by your employer. You enter your expenses and any reimbursements on Form 2106, and the allowable amount is then transferred to Line 20 of Schedule A (unreimbursed employee expenses), where it is subject to the 2% AGI floor along with other miscellaneous deductions; see ¶19.1. If you are using the standard mileage rate of 31 cents per mile (¶43.1) for 1996 vehicle expenses, and you were not reimbursed by your employer for any job expenses, you may file Form 2106-EZ.

You may enter your unreimbursed expenses directly on Line 20 of Schedule A without having to complete Form 2106 or Form 2106-EZ if you are not claiming any job-related travel, local transportation, meal, or entertainment expenses and you received no employer reimbursement at all for any of your other job costs (such as education expenses, union dues, or uniforms).

|                                       |                                           |
|---------------------------------------|-------------------------------------------|
| Agency fees for job, ¶19.7            | Gasoline taxes, ¶43.2                     |
| Airfares, ¶20.5                       | Gifts, ¶20.25                             |
| Auto club membership, ¶43.2           | Home office expenses, ¶19.13              |
| Auto expenses, ¶43.1                  | Hotel costs, ¶20.5                        |
| Books used on the job, ¶19.5          | House-hunting costs, ¶21.5                |
| Bond costs, ¶19.24                    | Instruments, ¶19.11                       |
| Car insurance premiums, ¶43.2         | Labor union dues, ¶19.5                   |
| Cleaning costs, ¶19.6                 | Laundry, ¶19.6                            |
| Commerce association dues, ¶19.5      | Legal expenses, ¶19.26                    |
| Commuting costs, ¶20.2                | Local transportation, ¶20.1               |
| Computers, ¶19.9                      | Lodging, ¶20.5                            |
| Convention trips, ¶20.12, ¶20.14      | Magazines, ¶19.5                          |
| Correspondence course, ¶19.16         | Malpractice liability premiums, ¶40.5     |
| Depreciation, ¶42.1                   | Meals, ¶20.3, ¶20.4                       |
| Dues, ¶19.5                           | Medical examinations, ¶17.2               |
| Educational expenses, ¶¶19.15–19.23   | Membership dues and fees, ¶19.5           |
| Employment agency fees, ¶19.7         | Motel charges, ¶20.5                      |
| Entertainment expenses, ¶¶20.15–20.27 | Moving expenses, ¶21.5                    |
| Equipment, ¶¶19.9–19.11               | Parking fees, ¶43.2                       |
| Foreign travel costs, ¶20.11, ¶20.14  | Passport fees for business travel, ¶20.11 |
| Furniture, ¶19.13, ¶21.5              | Pay turned over to employer, ¶2.9         |
| Garage rent, ¶43.2                    | Periodicals, ¶19.5                        |
| Gasoline, ¶43.2                       | Protective clothing, ¶19.6                |
|                                       | Rail fares, ¶20.5                         |
|                                       | Reimbursed expenses, ¶¶20.30–20.34        |
|                                       | Safety helmets, ¶19.6                     |

|                                |                                           |
|--------------------------------|-------------------------------------------|
| Safety shoes, ¶19.6            | Trade association dues, ¶19.5             |
| Secretarial convention, ¶20.12 | Transportation and travel expenses, ¶20.1 |
| Subscriptions, ¶19.5           | Tuition, ¶¶19.15–19.23                    |
| Taxi fares, ¶20.5              | Typewriter, ¶19.10                        |
| Telegrams, ¶19.14              | Uniforms, ¶19.6                           |
| Telephone calls, ¶19.14        | Union dues, ¶19.5                         |
| Toll charges, ¶43.2            | Work clothes, ¶19.6                       |
| Tools, ¶19.11                  |                                           |



### Life Insurance Agents and Food Deliverers

Statutory employees, such as full-time life insurance salespersons, may deduct expenses on Schedule C and so avoid the 2% AGI floor; see ¶40.5 for further details.

## ¶19.4 Job Expenses Not Subject to the 2% AGI Floor

**Impairment-related work expenses.** Unreimbursed impairment-related work expenses are reported on Form 2106 (or Form 2106-EZ where eligible) and then the unreimbursed portion is entered on Line 27 of Schedule A as a miscellaneous itemized deduction that is *not* subject to the 2% AGI floor. You have to show:

1. You are handicapped. A handicapped person must have a physical or mental disability which results in a functional limitation to employment or which substantially limits one or more major life activities. Generally, showing blindness or deafness will meet this test, but other disabilities that impair your ability to walk, speak, breathe, or perform manual tasks also may qualify if they limit the ability to work.
2. You incur the expenses in order to work. The expenses must be ordinary and necessary to allow you to work. Attendant care services at a place of employment which are necessary for you to work are also deductible.

**Expenses of performing artists.** As a performing artist, you may deduct job expenses from gross income, whether or not itemized deductions are claimed, if you have:

1. Two or more employers in the performing arts during 1996 with at least \$200 of earnings from at least two of them.
2. Expenses from acting or other services in the performing arts that exceed 10% of gross income from such work; and
3. Adjusted gross income (before deducting these expenses) that does not exceed \$16,000.

If you are married, a joint return must be filed to claim the deduction, unless you lived apart from your spouse during the whole year. The \$16,000 adjusted gross income limitation applies to your combined incomes. If both spouses are performing artists, the \$16,000 adjusted income limit applies to the combined incomes, but each spouse must separately meet the two-employer test and 10% expense test for his or her job expenses to be deductible on the joint return.

You report the performing artist expenses on Form 2106 (or Form 2106-EZ where eligible) and enter the total as a “write-in amount” on Line 30 of Form 1040, instead of on Schedule A. Write “QPA” next to Line 30. If you do not meet the tests, the expenses are deducted on Schedule A subject to the 2% AGI floor.

**Moving expenses.** Moving expenses to a new job location are not subject to the 2% AGI floor; *see* Chapter 21.

**Jury duty fees turned over to your employer.** If you receive your regular pay while on jury duty and turn over your jury duty fees to your employer, report the fees as other income on Line 21, Form 1040, and claim an offsetting deduction on Line 30. Write “Jury pay” next to Line 30.

## ¶19.5 Dues and Subscriptions

You may deduct as miscellaneous itemized deductions, subject to the 2% AGI floor on Schedule A, dues paid to a—

- Professional society if you are a salaried lawyer, accountant, teacher, physician, or other professional.
- Trade association if it is conducted for the purpose of furthering the business interests of its members.
- Stock exchange if you are a securities dealer.
- Community “booster” club conducted to attract tourists and settlers to the locality where the members do business.
- Chamber of Commerce if it is conducted to advance the business interests of its members.

**Union costs.** Union members may deduct as “miscellaneous” itemized deductions, union dues, and initiation fees. Similarly, non-union employees may deduct monthly service charges to a union. An assessment paid for unemployment benefits is deductible if payment is required as a condition of remaining in the union and holding a union job. Voluntary payments to a union unemployment benefit or strike fund are not deductible.

No deduction is allowed for mandatory contributions to a union pension fund applied toward the purchase of a retirement annuity; the contributions are treated as the cost of the annuity. Furthermore, to the extent that an assessment covers sick, accident, or death benefits payable to you or your family, it is not deductible. Similarly, an assessment for a construction fund to build union recreation centers was disallowed by the Tax Court, even though the payment was required for keeping the job.

Campaign costs for running for union office are not deductible.

**Subscriptions.** Subject to the 2% AGI floor, you may claim as miscellaneous itemized deductions unreimbursed payments for job-related subscriptions to professional journals and trade magazines.

## ¶19.6 Uniforms and Work Clothes

The cost of uniforms and other apparel, including their cleaning, laundering, and repair, is deductible *only* if the clothes are:

1. Required to keep your job; *and*

2. Not suitable for wear when not working.

The deduction is subject to the 2% AGI floor.

**Special work clothes.** Courts have held that the cost of special work clothes that protect you from injury is deductible even if you are not required to wear them to keep your job. However, you may not deduct the cost of special clothing, such as aprons and overalls, which protect your regular street clothing. Nor may you deduct the cost of ordinary clothes used as work clothes on the grounds that: (1) they get harder use than customary garments receive; (2) they are soiled after a day’s work and cannot be worn socially; or (3) they were purchased for your convenience to save wear and tear on your better clothes. For example, a sanitation inspector, a machinist’s helper, a carpenter, and a telephone repairman were not allowed to deduct the cost of their work clothes.

**Employer allowance.** An allowance paid by your employer for work clothes or a uniform is not reported as income, unless you do not substantiate the expenses to your employer. If you do substantiate the expenses, those exceeding the reimbursement are reported on Form 2106, and the deduction is subject to the 2% AGI floor; *see* ¶20.30.

**High-fashion work clothes.** That your job requires you to wear expensive clothing is not a basis for deducting the cost of the clothes if the clothing is suitable for wear off the job.

**Deductions allowed.** Deductions for costs of uniforms and work clothes have been allowed to—

|                                                                                                                   |                                                                                                  |
|-------------------------------------------------------------------------------------------------------------------|--------------------------------------------------------------------------------------------------|
| Airline pilot                                                                                                     | Factory worker for safety shoes                                                                  |
| Bakery salesperson—for a uniform with a company label                                                             | Firefighter                                                                                      |
| Baseball player                                                                                                   | Hospital attendant for work clothes; he came in contact with patients having contagious diseases |
| Bus driver                                                                                                        | Jockey                                                                                           |
| Cement finisher for gloves, over-shoes, and rubber boots                                                          | Letter carrier                                                                                   |
| Civilian faculty members of a military school                                                                     | Meat cutter for special white shoes                                                              |
| Commercial fisherman for protective clothing, such as oil cloths, gloves, and boots                               | Musician for formal wear                                                                         |
| Dairy worker for rubber boots, white shirts, trousers, and cap worn only while inside the dairy                   | Paint machine operator for high top shoes and long leather gloves                                |
| Entertainer for theatrical clothing used solely for performances                                                  | Plumber for special shoes and gloves                                                             |
| Exotic dancer for breast implants used as a “stage prop” essential to her business; <i>see</i> Example 8 in ¶19.8 | Police officer                                                                                   |
| Factory foreman for white coat bearing the word “foreman” and the name of the company                             | Railroad conductor                                                                               |
|                                                                                                                   | Railroad firefighter for boots, leather gloves, raincoat, caps, and work gloves                  |

## EXAMPLES

1. A painter may not deduct the cost of work clothing consisting of a white cap, a white shirt, white bib overalls, and standard work shoes. The clothing is not distinctive in character as a uniform would be. That his union requires him to wear such clothing does not make it a deductible expense.
2. A tennis pro who taught at private clubs was not allowed to deduct the cost of tennis outfits or shoes required for his job. He did not wear them outside of work and argued that he replaced the shoes every few weeks to reduce the chances of injury. However, the Tax Court upheld the IRS's disallowance of his deductions because the clothes and shoes are suitable for everyday wear; warm-up suits and tennis clothes are fashionable and frequently worn as casual wear. Furthermore, there was no evidence that his tennis shoes reduced chances of injury.

Your claim of a work clothes deduction is helped if your employer requires you to wear a uniform. Uniform costs of reservists and service persons are discussed at ¶35.8.



## Cleaning and Laundering

If you are allowed to deduct the cost of work clothes and uniforms, you also may deduct the cost of cleaning and laundering them. Also, courts have allowed the cost of cleaning and laundering in situations where:

- The clothes could only be worn one day at a time because they became too dirty.
- Dirty clothes were a hazard; they became baggy and might have gotten caught in machinery.
- Clothes were worn only at work and a place for changing clothes was provided by the employer.
- A meat cutter had to wear clean work clothes at all times.

## ¶19.7 Expenses of Looking for a New Job

You may deduct expenses of looking for a new job in the *same line of work*, whether or not a new job is found. The deduction is subject to the 2% AGI floor. If you are unemployed when seeking a new job, and the period of unemployment has been substantial, the IRS may disallow the deduction.

## EXAMPLE

The IRS disallowed the driving expenses of an unemployed secretary on the ground that she was not currently employed. The Tax Court disagreed and held that for purposes of deducting job-hunting expenses, she could still be considered in the business of being a secretary. She had worked as an administrative secretary with Toyota in San Francisco. The firm relocated, resulting in a

100-mile-per-day commute. She quit her job at the end of January 1984. From February to November 1984, she drove her Cadillac El Dorado over 4,600 miles looking for a new job. The Tax Court allowed her a depreciation deduction of \$2,880 and \$981 for car operating costs.

Expenses of seeking your *first job* are not deductible, even if a job is obtained. Also, expenses of looking for a job in a different line of work are not deductible, even if you get the job.

The IRS may also dispute the deduction of search expenses of a previously employed professional who forms a partnership.

## EXAMPLE

A CPA working for a firm decided to go out on his own. After a period of investigation, he formed a partnership with another CPA. The IRS disallowed his deduction of search expenses, claiming his expenses were incurred in a new business. As an employee he was in a different business than that of a self-employed practitioner. Thus, the expenses should be capitalized as a cost of setting up or organizing the partnership. The Tax Court disagreed, allowing the deduction. The travel expenses were incurred to seek work as a CPA, whether as a self-employed or employed CPA.

**Travel expenses.** If you travel to find a new job in the same line of work, such as an interview in a distant city, you may deduct travel expenses, including living costs. If, during the trip, you also do personal visiting, you may deduct the transportation expenses if the trip was primarily related to your job search. Time spent on personal activity is compared with time spent looking for a job to determine the primary purpose of the trip. If the transportation expenses to and from the destination are not deductible, you may still deduct the expenses of seeking a new job while you are away.



## Employment Agency Fee

If your new employer pays the fee under an agreement with an agency, you may disregard the payment for tax purposes. However, if you pay the fee and deduct it as a job search expense and in a later year you are reimbursed by your employer, you must report the reimbursement as taxable income to the extent you received a tax benefit from the earlier deduction; see ¶12.8.

A company interested in your services may invite you to a job interview and agree to pay all of the trip expenses to its office, even if you are not hired. The company payment is tax free up to your actual expenses.

**Are you between jobs?** If you are between jobs and you continue to see and entertain your former customers, the IRS holds that you may not deduct the cost of entertainment and other business expenses during this period on the ground that you are not in business and earning income. However, the Tax Court in the following case allowed the deduction.



## EXAMPLE

Haft was a successful jewelry salesman earning as much as \$60,000 a year. In the fall of one year, he left his employer and started to look for a new connection. During the following year, he continued to maintain contacts with his former customers by entertaining buyers and their representatives. He deducted the expenses of entertaining and other business costs. The IRS disallowed the deduction, claiming he was not in business. The court disagreed. His lack of business income was temporary and resulted from a period of transition which lasted a reasonable time.

## ¶19.8 Unusual Job Expenses

The following are not typical deductible expenses. However, deductions in the following cases have been allowed.

## EXAMPLES

1. **Shoeshine expense of a pilot.** Company rules required a commercial airline pilot to look neat, keep his hair cut, and wear conservative black shoes, properly shined. The pilot deducted as a business expense \$100 for his haircuts and \$25 for his shoe shines. The IRS disallowed the deductions, but the Tax Court allowed the cost of the shoe shines. The shoes were of a military type which he wore only with his pilot's uniform. The cost of keeping up a uniform is deductible. The haircuts were merely nondeductible personal expenses.
2. **Depreciation on furnishings bought by executive for his company office.** Following a quarrel with an interior decorator, a sales manager bought his own office furniture when his firm moved to new quarters. Rather than complain or ask for reimbursement, he footed the bill and deducted depreciation. The IRS disallowed the deduction, claiming the expense was that of his company. The Tax Court allowed the deduction. The manager's action was unusual, but prudent. He did not want to cause difficulties, and at the same time had to maintain his image as a successful manager. His expenses for furniture were appropriate and helpful.
3. **Salesman's cost of operating a private plane.** Sherman flew his own plane to visit clients in six southern states and deducted \$18,000 as operating costs of the plane. The IRS disallowed the deduction, claiming there was no business reason for the plane. He could have taken commercial flights or used a company car to reach his clients. Furthermore, his company did not reimburse him for the private airplane costs, although it would cover costs of his car and commercial air travel. Finally, the amount of airplane expenses was unreasonable compared to his salary of \$25,000. Sherman convinced the Tax Court that use of a private airplane was the only reasonable way he could cover his six-state sales area. He showed that most of his clients were not near commercial airports. Although the airplane costs were large in relation to his salary, they were still reasonable and, therefore, deductible.
4. **Executive's purchase of blazers for sales force.** Jetty, the president of an oil equipment manufacturing firm, thought that he could generate goodwill for the company if employees who attended industrial trade shows wore a blazer and vest set in the company colors. He personally paid and deducted \$6,725 for 27 blazers and vests. The IRS disallowed the deduction on the grounds that it was a company expense and that Jetty should have sought reimbursement from the company. The Tax Court allowed the deduction. Paying for the clothes was a legitimate business expense for Jetty since he depended on bonuses for a large portion of his pay, and, as company president, he had responsibility for seeing to it that there were profits to share in. Furthermore, the outlay was not the type of expense covered by the company's manual on expense reimbursements.
5. **Repayment of layoff benefits to restore pension credit.** When he was laid off, an employee received a lump-sum payment from his company based on his salary and years of service. When he was rehired a year later, he repaid the lump sum in order to restore his pension credits and other benefit rights. The IRS ruled that he may deduct the repayment as a condition of being rehired; the repayment was required to restore employee benefits.
6. **Teaching supplies.** The IRS does not allow teachers a deduction for school supplies. Some courts have been lenient and have allowed teachers to deduct out-of-pocket expenses. In one case, however, a teacher could not convince a court that his deduction for the cost of paper, pens, glue, and other supplies was a business expense. He could not support his claim that the school did not supply enough equipment.
7. **Politician's expenses.** Elected officials may incur out-of-pocket expenses in excess of the allowances received from the government. They may deduct as miscellaneous deductions their payment of office expenses such as salaries, office rent, and supplies. Part-time officials may claim the deduction. The expenses are deductible even if they exceed the official's income.
8. **Depreciation for exotic dancer's breast implants.** Hess, an exotic dancer, enlarged her breasts to the abnormal size of 56N and claimed a \$2,088 depreciation deduction for their cost. The IRS disallowed the deduction claiming that cosmetic surgery is a personal expense. The Tax Court disagreed. Hess's expenses were incurred solely in furtherance of her business and not for her own personal benefit. The breast implants were not of the kind that women usually get to enhance their appearance. Rather, Hess enlarged her breasts to a "freakish" size to substantially increase her annual income, which she did. The court also compared the implants to special work clothes (¶19.6), required for a job and not for personal wear. As an exotic dancer, Hess's large breasts are like a "costume" needed to keep her job. Although she could not remove them daily, she would have, if possible, because they caused her serious medical problems.

## Computers, Phones, and Home Office Costs of Employees

Computers and cellular phones

See ¶

19.9

Calculators, copiers, fax machines, and typewriters

19.10

Small tools

19.11

Automobile used for work

19.12

Home office deductions restricted

19.13

Telephone costs

19.14

## ¶19.9 Computers and Cellular Phones

Computers (and peripherals) and cellular phones are treated as “listed property” subject to deduction restrictions: To get a first-year expensing deduction (¶42.3) or to claim any type of depreciation, the computer or cellular phone must be used for the convenience of your employer and also be required as a condition of your job. The IRS strictly interprets these requirements.

**Computer.** A letter from your employer stating that a computer is needed for your position does not by itself satisfy the deduction tests. Even where your employer encourages use of a personal computer that is used for basic job requirements, the IRS requires proof that you need your own computer to do your job because your employer does not provide one, or because the computer supplied by your employer is not adequate for your job. In the following Examples, the IRS disallowed depreciation writeoffs.

### EXAMPLES

1. An electric company offers to help pay for its engineers' personal computers where they will improve productivity. Qualifying engineers receive extra pay and must buy a computer meeting company specifications, take approved computer courses, and agree to restrictions on resale of the computer. An engineer buys a computer and uses it 95% of the time for writing business memos and reports, and studying business flow charts. He does not use the computer for entertainment.

The IRS held that although the engineer's computer was work related and benefited his employer, buying a computer was not required for his job; it was not “inextricably related” to proper job performance. Further, his participation in the employer's computer program was optional, not mandatory.

2. A professor of nursing, trying to keep her temporary position, bought a personal computer, needing a word processor for independent research papers and to document her qualifications for research grants. The research and external grant support were implied university requirements for faculty appointments. She did not have access to university word-processing equipment during regular work hours; and because of her class-

room responsibilities, her research and grant development work had to be done on her own time. To help her pursue outside grants, the university bought her a “modem” that allowed a phone hook-up with its computer at night. Her computer was used 100% for research and grant work.

As in Example 1, the IRS held that use of the computer was not “inextricably related” to proper job performance and did not qualify for a depreciation writeoff. Furthermore, there was no evidence that employees who did not use computers were professionally disadvantaged.

3. The IRS held that an insurance agent could not deduct depreciation for a laptop computer he used to help develop insurance plans for clients. The insurance company encouraged its agents to buy the computer because office computers were not generally accessible. According to the IRS, it is not enough that the agent's productivity increased or that he used the computer solely for business. Purchasing the computer was optional, not a mandatory job requirement. Employees who did not purchase computers were not professionally disadvantaged.
4. The IRS barred a third-grade teacher from deducting the cost of a Macintosh computer because it was not *required* for her job. She bought the computer using an interest-free loan from the school after the school decided that report cards and student evaluations would have to be prepared on a Macintosh instead of being written. The Tax Court and an appeals court sided with the IRS. It may have been convenient for the teacher to use a home computer but it was not required. Other teachers were able to timely complete their duties using school computers.



### Tax Court Allows Computer Deduction

The Tax Court allowed a first-year expensing deduction to a working couple who used the same home computer given these facts: The husband, a professor, used it to store historical data; the wife, a state transportation planner, used it to do extensive number crunching. What apparently won the decision for the couple was evidence that (1) the husband did not have access to a computer at the university, and (2) the state office in which the wife worked did not have funds to buy a computer. The court held that the use of the computer was necessary for them to properly do their jobs, and as the purchase of a computer spared their employers from having to provide them with computers, the purchase was for the employers' convenience.

In a later case, a telemarketing sales manager was allowed a first-year expensing deduction for a home computer and printer used to prepare reports. The key to winning the deduction was her supervisor's testimony that as a mid-level manager, she could not enter the office after regular hours to use a company computer, and that she was able to keep up with the volume of sales reports she was required to submit by using her home computer and accessing information via modem.

**Cellular phones.** The IRS has not released specific guidelines or rulings covering deduction requirements for cellular phones. In general, the “convenience of the employer” and “job condition” tests apply.

**Claiming a deduction.** If you can meet the “convenience of the employer” and “job condition” tests for a computer or cellular phone, and the unit is used more than 50% of the time for your job, you may write off up to \$17,500 of the cost under the first-year expensing rules; see ¶42.3, or regular five-year MACRS depreciation rates may be used; see ¶42.10. If business use of the unit is 50% or less, you may not use first-year expensing or regular MACRS but you may claim straight-line depreciation.

First-year expensing or depreciation is claimed on Form 4562 and then entered on Form 2106 or Form 2106-EZ along with other job-related costs. The deduction from Form 2106 or Form 2106-EZ is subject to the 2% AGI floor for miscellaneous deductions on Schedule A; see ¶19.1. If business use in a later year is 50% or less, see ¶42.10 for recapture rules.

You need to keep records documenting your percentage of business use for a computer or cellular phone.

## ¶19.10 Calculators, Copiers, Fax Machines, and Typewriters

The listed property requirements applied to computers and cellular phones (¶19.9) do not apply to calculators, copiers, fax machines, adding machines, and typewriters. This means that the restrictive convenience of the employer and job condition rules do not apply. However, to depreciate the cost of such equipment, you should be ready to prove that you need the equipment for your job, and keep a record of the time it is used for business. To claim first-year expensing (¶42.3), rather than regular depreciation, you must use the equipment *more* than 50% of the time for business.

## ¶19.11 Small Tools

If you furnished your own small tools used on your job, you may deduct their cost if they are not expected to last beyond a year. The deduction is subject to the 2% AGI floor. The cost of tools with a useful life of more than a year must be recovered through depreciation or first-year expensing; see ¶42.3. Be prepared to substantiate your deduction with receipts showing the cost and type of tools purchased, and the business necessity for them.

## ¶19.12 Automobile Used for Work

If you buy a car that you use for work, you generally may claim the IRS mileage allowance or deduct actual unreimbursed expenses on Form 2106. If you claim actual expenses, you are allowed to deduct

depreciation only if use of the car is required for the job and for the convenience of the employer. For a car bought in 1996, the maximum depreciation deduction is \$3,060, reduced by the percentage of personal use.

The IRS standard mileage allowance is discussed at ¶43.1.

Depreciation rules, including annual deduction limits, are at ¶43.3.

## ¶19.13 Home Office Deductions Restricted

The law severely limits employees from claiming deductions for home office expenses by setting conditions most employees cannot meet. To deduct office expenses, the office must be *exclusively used* on a *regular* basis as either a—

1. Principal place of business, or
2. Place of business to meet customers, clients, or patients for the convenience of the employer.

Under these two tests, the IRS has consistently barred employees from claiming home office deductions.

The *Soliman* decision of the Supreme Court provides the following two tests to determine whether a home office is a principal place of business: (1) the relative importance of the work done at each business location; and (2) the amount of time spent at each location. In determining the principal place of business, the IRS first applies Test (1) from *Soliman*, comparing the characteristics of the work done at each business location. Weight is given to the place where patients, clients, or customers are met, where goods are delivered or services are performed; see Examples 1 and 2 below. If Test (1) is inconclusive, the IRS applies Test (2) above. The fact that the office serves some business function, such as a place to do administrative paperwork, does not suffice to claim a deduction, as illustrated by the *Soliman* decision in Example 3 below.

### EXAMPLES

1. **Teacher.** Charlie, a teacher, spends 25 hours a week at school and 35 hours a week at home grading papers and tests, and preparing lectures. According to the IRS, the most important part of a teacher's business is to teach and meet with students at the school. The work done at the home office, although essential and more time consuming, is less important than school instruction. Therefore, applying Test (1), the teacher's principal place of business is the school and not the home office.
2. **Plumber.** Joe, a plumber, spends 40 hours a week at customers' homes and 10 hours a week in his home office talking with customers, ordering supplies, and scheduling appointments. Applying Test (1), the IRS holds that a plumber's business is installing and repairing plumbing at customers' homes. The work done from the home office, although essential, is less important and takes less time than Joe's service calls to customers.
3. **Anesthesiologist.** Soliman, an anesthesiologist, deducted expenses of his home office, where he spent 10–15 hours per



week doing all of his administrative work and pre-treatment planning. He had no office space at the three hospitals where he administered anesthesia and cared for patients for 30–35 hours per week. The Tax Court allowed the deduction, holding that the home office was essential to his work. The Supreme Court disagreed. That the home office was essential to his practice was irrelevant; his principal place of business was at the hospitals where he practiced.

According to the Supreme Court, whether a home office is the principal place of business depends on two considerations: (1) The functions at each business location and the relative importance of each. The place where a person is required to meet with clients or patients, deliver goods or perform services is generally the principal place of business, especially if that place has unique or special characteristics, as a hospital does. (2) The time spent at each location if it is difficult to make a determination under (1).

4. Fred Jones, a salesperson, makes most of his sales to customers by telephone or mail from his home office. He spends an average of 30 hours a week there and 12 hours a week visiting prospective customers to deliver products and occasionally take orders. According to the IRS, the essence of Fred's business as a salesperson requires him to make telephone or mail contact with customers primarily from the office in his home. Visiting customers is less important to his business than the activities performed from his home office. Further, a comparison of the 30 hours per week spent in the home office with the 12 hours per week spent visiting customers also supports the conclusion that Fred's home office is his principal place of business. Therefore, he may deduct his home office expenses.

**Note:** The IRS warns that where you have two or more business locations but none qualifies as a principal place of business under the Supreme Court's "relative importance" or "time" test, no deduction will be allowed unless customers, clients, or patients are seen at the home office.

**Exclusive use** means that the space used as an office must not be used for personal purposes such as a family den. Even if you meet this exclusive-use test, a deduction is barred unless the office is used regularly as your principal place of business or to see customers, clients, or patients.

### EXAMPLE

A husband and wife both teach in an elementary school. Neither can use the school facilities after 5 P.M. and so they are required to work at home, preparing lessons, constructing charts and learning materials, and reading educational literature. They do this in a room exclusively used for this purpose. Despite exclusive business use of the room, no home office deduction is available; the room is not their principal place of business; see Example 1 earlier.

**Office in separate structure.** If you maintain an office in a separate structure located on the same lot as your home, such as a garage, studio, or barn, and the structure is used exclusively and regularly for work required by your employer, your unreimbursed expenses

are deductible as a miscellaneous itemized deduction subject to the 2% AGI floor.

**Rentals to employer.** Home office deductions may not be claimed by employees who rent home office space to their employer.

**Investors.** Home office deductions may not be claimed by investors who use a home office to review investments and make investment decisions unless the activity constitutes a business; see ¶19.24.

**Deductible expenses.** Qualifying for the home office deduction determines whether you may deduct the allocable business part of the cost of home insurance, maintenance, utilities, rent, and depreciation (if you own your home or apartment). Real estate taxes and mortgage interest are fully deductible on Schedule A, regardless of your use of the home. Expenses, such as maintenance, depreciation, or rent, allocated to your home office use are claimed as miscellaneous expenses on Line 20 of Schedule A, subject to the 2% AGI floor. You must first enter the expenses on Form 2106 if you were partially reimbursed by your employer. Form 2106 (or Form 2106-EZ if you qualify) must also be used if you are claiming automobile or job travel costs. Allocated home office expenses may not exceed income from your job.

You may allocate expenses to the home office by dividing the number of square feet of space used as an office into the total number of square feet in the home. Apply the resulting percentage to the total expenses. If the rooms in your home are approximately the same size, you can divide total rooms in the house by the room used as an office. For example, if one room out of a five-room apartment is used for an office,  $\frac{1}{5}$ , or 20%, of deductible home expenses are allocated to the use of the office.

To support your deduction, keep records to show how you allocated the expenses, in addition to cancelled checks, receipts, and other evidence of the expenses paid.

You need physical evidence of an office. A bare minimum is a desk, chair, and filing cabinet.

Retain business mail directed to your home.

Keep a record of business phone calls you make, particularly charges for long-distance telephone calls, and a diary of business visitors, including those who come to your home for entertainment.

**Self-employed persons.** The home office provisions as they apply to a self-employed person are explained at ¶40.11.

## ¶19.14 Telephone Costs

For business calls made outside of your employer's office or at home, keep a record or diary of business calls to support your deduction. To avoid the problem of allocating the costs of a single home phone for both business and personal use, consider installing a separate home phone for business use only. For long-distance business calls, you might ask the phone company to transfer the charges to your office phone.

**Deduction barred for basic charge of first phone line.** You may not claim as a deductible home office expense any part of the standard monthly charge for the first telephone line into your home. This disallowance rule only applies to the first telephone line. If you have more than one telephone line and use additional lines in a home office, costs for these lines remain deductible, subject to the restrictions at ¶19.13. The restriction does not affect deductibility of long-distance calls, phone rentals, or optional services such as call waiting, call forwarding, three-way calling, or extra directory listings.

## Deductible Education Costs

|                                      |            |
|--------------------------------------|------------|
| Types of deductible education costs  | See ¶19.15 |
| Deduction tests for education costs  | 19.16      |
| Law school costs                     | 19.17      |
| Courses taken by doctors and nurses  | 19.18      |
| Courses taken by teachers            | 19.19      |
| Professor's research expenses        | 19.20      |
| Leave of absence to take courses     | 19.21      |
| Trips taken for educational purposes | 19.22      |
| How to deduct education costs        | 19.23      |

## ¶19.15 Types of Deductible Education Costs

You can improve your job or professional skills by attending continuing education or refresher classes, advanced academic courses, or vocational training, and get an itemized deduction for the cost. The deduction is subject to the 2% adjusted gross income floor (AGI) for miscellaneous deductions; see ¶19.1.

To deduct education costs, you must show that the following conditions are met:

1. You are employed or self-employed;
2. You already meet the minimum requirements of your job, business, or profession; and
3. The course maintains or improves your job skills, or you are required by your employer or by law to take the course to keep your present salary or position.

The details of these requirements are explained at ¶19.16.

If the courses lead to a change of position or promotion within the same occupation, a deduction for their cost will usually be allowed if your new duties involve the same general type of work. However, where you are enrolled in a college degree program (bachelor of arts or science) the IRS is likely to disallow a deduction for the cost of the courses on the ground that the degree qualifies you for a new business or profession; see nondeductible courses below. The Tax Court has sided with the IRS.

**Nondeductible courses.** The cost of courses preparing you for a new profession or for meeting the minimum requirements for your

job is not deductible, even if you take them to improve your skills or to meet your employer's requirements. This rule prevents the deduction of law school costs; see ¶19.17. Furthermore, the cost of a bar review course or CPA review course is not deductible because it leads to a new profession as an attorney or CPA.

If courses lead to qualification for a new business or profession, no deduction is allowed even if you keep your current position.

## ¶19.16 Deduction Tests for Education Costs

You must meet an employment test to deduct educational expenses. Educational costs are not deductible if you are unemployed or inactive in a business or profession. The cost of "brush-up" courses taken in anticipation of resuming work is also not deductible. However, in one case, a court allowed an unemployed teacher to deduct the cost of tuition, fees, and books where the IRS conceded that the teacher, although unemployed, remained in the teaching profession while attending college classes.

You are not considered unemployed when you take courses during a vacation or temporary leave of absence; see ¶19.21.

If you are practicing your profession, the cost of courses leading to a specialty within that profession is deductible.

### EXAMPLE

A practicing dentist returned to school full time to study orthodontics while continuing his practice on a part-time basis. When he finished his training, he limited his work to orthodontics. The IRS ruled he may deduct the cost of his studies. His post-graduate schooling improved his professional skills as a dentist. It did not qualify him for a new profession.

**Minimum standards.** You may not deduct the cost of courses taken to meet the minimum requirements of your job. The minimum requirements of a position are based on a review of your employer's standards, the laws and regulations of the state you live in, and the standards of your profession or business. That you are presently employed does not in itself prove that you have met the minimum standards for your job.

If minimum standards change after you enter a job or profession, you are required to meet only the standards that existed when you entered.

The minimum standards for teachers are discussed at ¶19.19.

**Maintaining or improving job skills.** To be deductible, the education must maintain or improve your current job skills. That you are established in your position and that persons in similar positions usually pursue such education indicates that the courses are taken to maintain and improve job skills. However, the IRS may not allow a deduction for a general education course that is a prerequisite for a job-related course. If, as a consequence of taking a job-related course, you receive a substantial advancement and the IRS questions the deduction of the course costs, be prepared to prove that you took the course primarily to maintain or improve skills of your exist-

ing job. However, if the course leads to qualification for a new profession, the IRS will disallow a deduction even if the course also improves current job skills. For example, a deduction is not allowed for the cost of law school or medical school courses if they prepare you for a new profession; *see* ¶19.17 and ¶19.18. The IRS with Tax Court approval has also held that a deduction is not allowed for the cost of college courses that are part of a degree program; *see* ¶19.15.



### Are MBA Courses Deductible?

The cost of MBA courses is deductible if the courses enhance the skills required in your current position, are not a minimum job requirement, and do not qualify you for a new business. The IRS may question in a particular case whether there has been a change of business, particularly where taking the courses leads to a promotion. For a deduction, the courses must be related to your existing job responsibilities. The Tax Court has allowed deductions for MBA expenses where individuals with some managerial or administrative experience took the courses to improve job skills.

If your employer requires a master's degree as a minimum entrance requirement for your position, the cost of the courses is not deductible.

In one case, a college graduate who took a summer job before starting MBA courses was not allowed a deduction because he had not yet established himself in a business or employment; the summer position was just a temporary stage between schooling.

If your employer reimburses you for MBA courses that qualify for a deduction, the reimbursement is a tax-free working condition fringe benefit; *see* ¶3.6.

**Employer's requirement.** If, to retain your present job or rate of pay, your employer requires you to obtain further education, you may deduct the cost of the courses. The fact that you also qualified for a raise in pay or a substantial advancement in your position after completing the courses should not bar the deduction.

The employer's requirement must be for a bona fide business reason, not merely to benefit you. Only the minimum courses necessary for the retention of your job or rate of pay are considered by the IRS as taken to meet your employer's requirement. You must show any courses beyond your employer's minimum requirements were taken to maintain or improve your job skills.

## ¶19.17 Law School Costs

The IRS does not allow deductions for law school courses, because they qualify you for a new profession. Courts support the IRS position. A deduction is not allowed even if you do not intend to practice law. For example, teachers who took law school courses have been disallowed deductions although they intended to continue teaching.

**Bar review courses.** The costs of bar review courses and the bar exam are not deductible, even where you are seeking admission to the bar of a second state. However, fees paid to state bar admission authorities have been held to be amortizable over an attorney's life expectancy.

An attorney who practices law in one state may not deduct the later costs of getting a degree necessary to the practice of law in another state.

**Additional legal education.** An attorney may deduct the cost of a master's degree program (LL.M.). You must practice as an attorney before the expenses of further legal education are deductible.

### EXAMPLE

The Tax Court allowed a lawyer to deduct educational expenses to obtain an LL.M. degree where he worked for a law firm as a beginning lawyer during the summer between graduating from law school and starting work on the LL.M. degree. He was admitted to the state bar before he graduated from law school, and the work he did during the summer was normally assigned to beginning lawyers rather than to law students.

In another case, the IRS and Tax Court did not allow a deduction to a law school graduate who took LL.M. courses before passing the state bar or working as an attorney.

## ¶19.18 Courses Taken by Doctors and Nurses

The IRS allows general practitioners to deduct the cost of short refresher courses, even though the courses relate to specialized fields. These courses maintain or improve skills and do not qualify the doctor for a new profession.

A practicing psychiatrist may deduct the cost of attending an accredited psychoanalytic institute to qualify to practice psychoanalysis. A social worker has also been allowed a deduction for the cost of psychoanalysis. In one case, a psychiatrist was allowed by the Tax Court to deduct the cost of personal therapy sessions conducted through telephone conversations and tape cassettes. The court was convinced that the therapy improved his job skills by eliminating psychological blind spots that prevented him from understanding his patient's problems.

A licensed practical nurse may not deduct the costs of a college program which qualifies him or her as a "physician's assistant," which is a new business. Physicians' assistants and practical nurses are subject to different registration and certification requirements under state law, and, more importantly, the physician's assistant may perform duties, such as physical examinations and minor surgery, which go beyond practical nursing duties.

## ¶19.19 Courses Taken by Teachers

You must meet the minimum level of education for your present position as set down by law or regulations before you may deduct the cost of courses. The educational requirements are those that existed when you were hired. If your employer set no tests fixing a minimum educational level, you meet the minimum requirements when you become a member of the faculty. Whether you are a faculty member depends on the custom of your employer. You are ordinarily considered a faculty member if: (1) you have tenure, or your service is counted toward tenure; (2) the institution is contributing toward a retirement plan based on your employment (other than Social Security or a similar program); or (3) you have a vote in faculty affairs.

**Employed teacher taking courses for teaching certificate.** That you are already employed as a teacher, with all the responsibilities of a teacher, may not establish that you have met the minimum educational requirements. A school system which requires a bachelor's degree before granting a permanent teaching certificate may grant temporary or provisional certificates after a person has completed a number of college credits. Renewal of the provisional certificate may be conditioned on the teacher's continuing education for a bachelor's degree. In this case, the IRS will disallow a deduction for the educational costs. The minimum requirements are not met until the teacher has the degree. Current Tax Court decisions follow the IRS position, although in the past the court took a contrary view.



### Teacher's Job Change

Elementary and secondary school teachers may deduct the cost of courses taken to make any of the following job changes: (1) elementary to secondary school classroom teacher; (2) classroom teacher in one subject (such as mathematics) to classroom teacher in another subject (such as art); (3) classroom teacher to guidance counselor; or (4) classroom teacher to principal.

The IRS held that a "discussion leader" in a college adult education program could not deduct the costs of a master's degree program that led to certification as a high school guidance counselor because this was a new business. The Tax Court disagreed, holding that the responsibilities of discussion leader are similar to the responsibilities of a school counselor. The court distinguished an earlier decision in which a classroom paraprofessional assistant was not allowed to deduct education costs that qualified her as a classroom teacher. The court considered this as a change in professions. A paraprofessional does not have the same control and responsibilities for classroom work as a classroom teacher.

## ¶19.20 Professor's Research Expenses

Research costs incurred by a college professor are deductible under this condition: He or she is appointed to lecture and teach with the understanding that research in the field will be carried on with the goal of incorporating the findings in teaching and writing. If this test is met, the IRS is satisfied that the research is an express requirement of the teaching position and that research expenses are deductible job expenses.

Deductible research costs include traveling expenses and stenographic and other costs of preparing a manuscript. If income is later realized from the research in the form of lecture or royalty fees, the previously deducted research costs may not again be deducted in determining the income realized from the research.

Expenses of a research project undertaken for a scholarly publication are not deductible if the research is not linked to an income-producing activity or job requirement.

## ¶19.21 Leave of Absence To Take Courses

If you are a teacher, the IRS will allow a deduction for full-time graduate courses you take during a leave of absence if these conditions are met: (1) the absence must not be for more than one year; and (2) upon completion of the education courses, the same type of employment must be resumed, although you may take a job with a new employer. You may also have to show that you had more than a vague intention to go back to your employment—for example, that you were actually negotiating for a new teaching position and that, in fact, you did obtain a position soon after finishing the graduate courses.

## ¶19.22 Trips Taken for Educational Purposes

No deduction is allowed for costs of travel claimed as a form of education. For example, no deduction will be allowed to a French teacher traveling to France to maintain general familiarity with the French language and culture, or to a social studies teacher traveling to learn about or photograph people and customs.

A deduction may still be allowed for travel that qualifies as a business expense, as, for example, if a teacher must travel abroad to do research that cannot be done elsewhere.



## ¶19.23 How To Deduct Education Costs

If your courses meet the requirements explained in ¶19.16, you may deduct the following education costs, subject to the 2% AGI floor on Schedule A:

1. Tuition, textbooks, fees, equipment, and other aids required by the courses.
2. Certain transportation costs discussed below.
3. Travel to and from a school away from home.
4. Lodging and 50% of meal expenses while at the school away from home. The IRS will not disallow traveling expenses to attend a school away from home or in a foreign country merely because you could have taken the course in a local school. But it may disallow your board and lodging expenses at the school if your stay lasts longer than a year.

**Local transportation expenses.** If your courses qualify for a deduction, under ¶19.16 you may deduct transportation costs of going from your job directly to school. According to the IRS, the return trip from school is also deductible if you are going to school on a *temporary* basis. If you take a one-time course or a course that lasts a few days or weeks, the IRS considers this temporary and you are allowed a deduction for your transportation to and from school. The IRS position is illustrated in the following Examples.

### EXAMPLES

1. You regularly work in Camden, New Jersey, and every night for three weeks you drive from home to attend a refresher course. The course is considered temporary. You may deduct the round-trip transportation costs between home and school. The deduction is allowed regardless of how far you travel.  
If you went directly from your job to the school, you may deduct transportation from work to school, and from school to home.
2. On six consecutive Saturdays, which are nonworkdays for you, you drive from home to attend a qualifying course. This is considered a temporary course. You are allowed a deduction for round-trip transportation between home and school, even though you are traveling on a nonworkday.
3. After work, you attend classes twice a week for one year. The IRS does not consider the course to be temporary. You may deduct the cost of going directly from work to school, but the costs of going between home and school are nondeductible.

**Travel and living expenses away from home.** “Away from home” as explained at ¶20.6 has a special tax meaning. You are not away from home unless you are away overnight.

Expenses of sightseeing, social visiting, and entertaining while taking the courses are not deductible. If personal reasons are your

main purpose in going to the vicinity of the school, such as to take a vacation, you may deduct only the cost of the courses and your living expenses while attending school. You may not deduct the rest of your travel costs.

To determine the purpose of your trip, an IRS agent will pay close attention to the amount of time devoted to personal activities relative to the time devoted to the courses.

**Where to claim educational expenses on your return.** The way you deduct educational expenses depends on your occupational status. If you are:

**An employee**—If you have education costs that are deductible under ¶19.16 but which have not been reimbursed by your employer, you generally deduct the expenses on Form 2106 or Form 2106-EZ. However, you do not need Form 2106 or Form 2106-EZ and may report your educational expenses directly on Schedule A as unreimbursed employee expenses if: (1) you are not claiming job expenses for travel, transportation, meals, or entertainment; and (2) you received no reimbursements for education expenses or any other job-related costs. If your expenses were partially reimbursed, you must use Form 2106; Form 2106-EZ may not be used.

Employer reimbursements, including advances of deductible expenses, are not reported as income on your Form W-2 if you substantiate the expenses to your employer and return amounts in excess of the substantiated expenses. If these substantiation tests are not met or if the education costs are not deductible under ¶19.16, the expenses are reported as income on your Form W-2, and you must claim them on Form 2106 (or Schedule A if Form 2106 is not needed) as if they were unreimbursed. If your employer pays the tuition directly to the educational institution, you are not required to report the payment in any way on your return.

Unreimbursed costs, such as travel, tuition, books, fees, and meals from Form 2106 or Form 2106-EZ, are deductible only if you claim itemized deductions. They are claimed as miscellaneous itemized deductions and are subject to the 2% AGI floor when included with other miscellaneous deductions on Schedule A.

**Teacher on sabbatical**—Where a school system has a policy of paying teachers full salary during sabbatical leaves, a teacher on sabbatical may be required to pay a fixed percentage of salary into a fund to pay substitute teachers. A teacher reports the full amount of the salary paid during the sabbatical but may claim payments to the fund as miscellaneous itemized deductions subject to the 2% AGI floor.

**A self-employed business owner or professional**—If your education costs qualify under ¶19.16, you deduct all of your education costs on Schedule C. You also attach a statement to your return explaining your deduction and the relationship of the education to your position.

**A veteran receiving educational benefits from the VA**—Educational assistance from the Department of Veterans Affairs (VA) is tax free, whether it covers educational or living expenses. The portion of the payment covering educational costs reduces your deductible educational expenses. If you use only part of the VA payment for qualifying courses, reduce your deduction by the part of the VA reimbursement covering the qualifying courses. The portion of the reimbursement, if any, that covers living expenses does not affect your deduction.

## Investment, Legal, and Tax Advice Expenses

Checklist of deductible investment expenses  
Costs of tax return preparation and audits  
Deducting legal costs

See ¶  
19.24  
19.25  
19.26

## ¶19.24 Checklist of Deductible Investment Expenses

The following investment expenses are deductible as miscellaneous expenses on Schedule A subject to the 2% adjusted gross income (AGI) floor. In addition, the 3% reduction for total itemized deductions applies if your adjusted gross income exceeds \$117,950, or \$58,975 if married filing separately; see ¶13.8.

- Accounting fees for keeping records of investment income.
- Bank deposit loss if not federally insured; see ¶18.4.
- Casualty or theft losses of income-producing property such as stock certificates, but not rental or royalty property; the deduction is figured on Form 4684 and entered on Schedule A.
- Fees for collecting interest and dividends. Also deductible are fees paid to a bank that acts as dividend agent in an automatic dividend reinvestment plan of a publicly owned corporation. Costs of collecting tax-exempt interest are not deductible; expenses deducted on an estate tax return are also not deductible. Fees paid to a broker to acquire securities are not deductible but are added to the cost of the securities. Commissions and fees paid by an investor on the sale of securities reduce the selling price; a dealer, however, may deduct selling commissions as business expenses.
- Fees to set up or administer an IRA. The fees must be billed and paid separately from the regular IRA contribution.
- Guardian fees or fees of committee for a ward or minor incurred in producing or collecting income belonging to the ward or minor or in managing income-producing property of the ward or minor.
- Investment management or counsel fees. However, fees allocated to advice dealing with tax-exempt obligations are not deductible.
- Investment fees from non-publicly offered mutual fund, shown in Box 1e of Form 1099-DIV.
- Legal costs; see ¶19.26.
- Premiums and expenses on indemnity bonds for the replacement of missing securities. If part of the expenses are refunded in the year the expenses are paid, only the excess expense is deductible. A refund in a later year is taxable income to the extent the expenses were deducted and reduced your tax; see ¶12.8.
- Proxy fight expenses where the dispute involves legitimate corporate policy issues, not a frivolous desire to gain membership on the board.
- Safe deposit box rental fee or home safe to hold your securities, unless used to hold personal effects or tax-exempt securities.

- Salary of a secretary, bookkeeper, or other employee hired to keep track of your investment income.
- Subscriptions to investment services.
- Travel costs of trip away from home (¶20.6) to look after investments, or to confer with your attorney, accountant, trustee, or investment counsel about the production of income. If you have investment property in a resort area, keep proof that the trip was taken primarily to check your investment property, not to vacation. Nondeductible travel is discussed below.

**Computer used to manage investments.** Subject to the 2% floor, depreciation may be claimed; see ¶42.10.

**Managing investment property.** Expenses incurred in managing property held for income are deductible, even if the property does not currently produce income. Similarly, expenses incurred to avoid further losses or to reduce anticipated losses on such property are deductible.

**Rental or royalty expenses.** Expenses of earning royalty or rental income are deducted directly from royalty or rental income, rather than as itemized deductions subject to the 2% AGI floor.

### EXAMPLE

You pay deductible investment management fees of \$1,500; a tax preparation fee of \$500; and a safe deposit box fee of \$40. Your other miscellaneous expense deductions subject to the 2% floor are \$500 for unreimbursed job expenses. Your adjusted gross income is \$80,000. Your deduction after applying the 2% AGI floor is \$940, figured as follows:

|                              |                |
|------------------------------|----------------|
| Investment management fees   | \$1,500        |
| Tax preparation fee          | 500            |
| Safe deposit box fee         | 40             |
| Other miscellaneous expenses | 500            |
|                              | <u>\$2,540</u> |
| Less: 2% of \$80,000         | 1,600          |
| Total deductible             | <u>\$ 940</u>  |

**Nondeductible travel costs.** Investors may not deduct the costs of these types of trips:

- Trips to investigate prospective rental property.
- Trips to attend a convention, seminar, or similar meeting that deals with investment, financial planning, or the production or collection of income. Convention costs are deductible only in the case of a business activity; see ¶20.12.
- Trips to attend stockholder meetings. However, in a private letter ruling, one stockholder was allowed a deduction. He owned substantial stockholdings which had lost value because his corporation had been issuing stock to the public at prices below book value. He went to the annual shareholders' meeting to present a resolution requesting management to stop the practice; the resolution passed. Under such circumstances, the IRS held that the trip was directly related to his stockholdings and allowed him the deduction. The IRS distinguished his case from a ruling which bars most stockholders from deducting the cost of travel to an annual meeting. Here the stockholder's purpose in getting the resolution passed was more closely related to his investment activities than if he had attended the meeting, as most stockholders do, to pick up data for future investment moves.

**Hobby expenses.** For the limitations on deducting hobby expenses, see ¶40.9.

**Home office of an investor.** An investor may not deduct the costs of an office at home unless investing constitutes a business. For example, you get no deduction for use of a home office in your residence where you read financial periodicals and reports, and clip bond coupons. These activities are not considered a business.

### EXAMPLE

In his home office, Moller spent 40 hours a week managing four stock portfolios worth over \$13 million. However, an appeals court held he could not deduct home office expenses despite the time spent there managing his investment. To deduct home office expenses, Moller had to show he was a trader. A trader is in a business; an investor is not. A trader buys and sells frequently to catch daily market swings. An investor buys securities for capital appreciation and income without regard to daily market developments. Here, Moller was an investor. He was primarily interested in the long-term growth potential of stock. He did not earn his income from the short-term stock turnovers. He had no significant trading profits.

## ¶19.25 Costs of Tax Return Preparation and Audits

You may deduct your payment of fees charged for the services listed below, subject to the 2% AGI floor and the 3% reduction if AGI exceeds \$117,950 (\$58,975 if married filing separately); see ¶13.8.

- Preparing your tax return or refund claim involving any tax;
- Preparing and obtaining a private IRS ruling, including IRS filing fees; and
- Representing you before any examination, trial, or other type of hearing involving any tax.

The term “any tax” covers not only income taxes but also gift, property, estate, or any other tax, whether the taxing authority be federal, state, or municipal.

**Tax practitioner’s fees.** Deductible fees for services of tax practitioners are claimed on Schedule A as miscellaneous itemized deductions on the tax return for the year in which the fee was paid. For example, if in March 1996 you pay an accountant to prepare your 1995 return, the fee is deductible on your 1996 return.

You deduct fees related to preparing Schedule C or F (and related business Schedules) on the Schedule C or F, thereby avoiding the 2% AGI floor on Schedule A. In one case, the Tax Court allowed a Schedule C deduction for a \$55 tax preparation fee claimed by a self-employed lumberjack, although nonbusiness income was also reported on his return. Any allocation to the nonbusiness income would have been minimal. The Court noted that the IRS’s position in disallowing the deduction reflected misguided zeal and was not only petty but impractical.

If you report rental or royalty income or loss on Schedule E, you deduct the allocated tax preparation fee on Schedule E.



### Allocate Fees for Tax Advice

There have been disputes over the deductibility of fees charged for general tax advice unconnected to the preparation of a return or a tax controversy. A deduction for fees charged for general tax advice not within these areas may be disallowed, unless the fee can be related to the production of business or investment income or the management of income-producing property. See the following Examples.

An accountant’s fee for arranging the purchase of real estate was deductible where the purchase was part of a plan to cut taxes; see the Collins Example at the end of this section.

**Personal checking account fees.** These are nondeductible, even though the checks are used for tax records. Similarly, the per-check fee on an interest-bearing NOW account is nondeductible. However, fees charged on a bank money-market account may be deductible if check writing is severely limited and writing excess checks forfeits the status of the account as a money-market account.

**Appraisal fees.** Approvals for determining a casualty loss or charitable donation are miscellaneous expenses.



### Deducting the Cost of This Book

The purchase of *Your Income Tax* in 1996 may be claimed as a miscellaneous expense deduction on your 1996 return. The cost, when included with other miscellaneous expenses, is subject to the 2% AGI floor. If you purchased the book in 1997, include the cost with your other miscellaneous expenses on your 1997 return.

### EXAMPLES

1. Stockholders of a closely held corporation negotiated with a publicly held company for a tax-free exchange of their stock. An accounting firm asked the IRS for a ruling to determine whether the exchange would be taxable or tax free. The accounting fee was \$8,602. Of this, \$7,602 was for the ruling and \$1,000 was for fixing the basis of the new stock. The stockholders deducted the full fee, which the IRS disallowed because the fee was not charged for the preparation of a tax return nor for representation at a contest of a tax liability.

The Tax Court disagreed in part. The fee paid for the ruling is deductible; it was connected with determining the extent of the stockholders’ liability, if any, in the proposed exchange. But a deduction cannot be allowed for the \$1,000 charged to determine the basis of the new stock. This was computed for the stockholders’ information, not for determining tax liability. The disallowed fee could be added to the cost basis of the stock.

2. Collins paid an accountant \$4,511 for tax advice to reduce his tax on a sweepstakes winning. He was advised to buy an apartment house under a contract obligation to make a large prepayment of interest (which was deductible under prior law). The accountant helped prepare contracts, escrow agreements, and other documents to implement the plan. Collins' deduction of his accountant's fee as a business expense was disallowed. The IRS held that the fee was a capital expense in acquiring the property. The Tax Court disagreed. The accountant was hired to minimize Collins' income tax through the purchase of the building and the terms of the purchase. Therefore, his fee was deductible.

## ¶19.26 Deducting Legal Costs

A legal expense is generally deductible if the dispute or issue arose in the course of your business or employment or involves income-producing property. Legal expenses for personal matters are generally not deductible. If you are self-employed, your deduction for legal fees arising from a business-related dispute is claimed on Schedule C. Legal expenses related to your job as an employee or to investment activities are claimed as miscellaneous itemized deductions subject to the 2% AGI floor. The IRS may disallow the deduction on the ground that the legal dispute does not directly arise from the business or income activity. Thus, for example, the cost of contesting the suspension of a driver's license for drunken driving is not deductible despite a business need for the license; the suspension arose out of a personal rather than a business-related activity. A deduction may also be disallowed where the dispute involves title to property. Legal fees incurred in obtaining an award of tax-free damages are not deductible.

For the deductibility of legal fees in organizing a new business; see ¶40.10.

**Employment suits.** The following Examples illustrate when legal costs for job-related matters may be deductible.

### EXAMPLES

1. Waldheim, a corporate officer, director, and stockholder, incurred legal fees in a suit to prevent his discharge. His legal costs were deductible.
2. An Army officer was allowed to deduct the cost of successfully contesting a court martial based on charges of misrepresentations in official statements and reports. He would have lost his position had he been convicted.
3. Tellier, a securities dealer, was convicted of mail fraud and securities fraud. He was allowed to deduct legal fees as business expenses related to his securities business. That he was found guilty of the criminal charge does not affect the deductibility of

the expense. The deduction of legal expenses is not disallowed on public policy grounds since a defendant has a constitutional right to an attorney.

4. In an alimony action, Gilmore was successful in preventing his wife from securing stock and taking control of corporations from which he earned practically all his income. He was not allowed to deduct his legal costs. The dispute did not arise from an income-producing activity; the fact that an adverse determination of the dispute might affect his income did not make the legal expenses deductible.
5. A doctor who attempted to bribe a judge to suspend his sentence for tax evasion was convicted of the bribe attempt and lost his license to practice medicine. He could not deduct his defense costs. His practice of medicine did not give rise to his need for an attorney. The fact that the conviction affected his ability to earn income was merely a consequence of personal litigation.
6. Siket, a police officer, was not allowed to deduct expenses of successfully defending a criminal charge of assault while off duty. The origin of the claim was personal, even though a conviction might have been detrimental to his position as a police officer. The arrest did not occur within the performance of his duties; he was off duty and in a different municipality at the time of the arrest.

The legal costs of defending against disbarment are deductible.



### Lawyer's Bill Should Be Itemized

Your lawyer should bill you separately or itemize fees for services connected with deductible items (collection of taxable alimony or separate maintenance payments; or preparation of tax returns, tax audits, and tax litigation) and nondeductible capital items (expenses incurred in purchase of property or dispute over title).

**Will contests and wrongful death actions.** Legal costs of a will contest are generally not deductible because an inheritance is not taxable income. Similarly, legal fees incurred to collect a wrongful death award (which is tax-free income) are not deductible.

### EXAMPLE

Parker, an heir who was left out of his grandmother's estate, sued to recover his inheritance. In a settlement, he received his share of his grandmother's property plus income earned on that property. The allocable portion of legal fees attributed to the income, which was taxable, was deductible; the balance of the fees was not deductible.





### Tax Advice and Tax Return Preparation

You may deduct legal fees paid in 1996 for preparing your tax return or refund claim, or for representing you in a trial, examination, or hearing involving any tax; see ¶19.25. Legal fees incurred in defending against a tax imposed by a foreign country are also deductible. However, legal fees incurred in reducing an assessment on property to pay for local benefits are not deductible; the fees are capital expenses which are added to basis.

A deductible legal fee, when included with other miscellaneous deductions, is subject to the 2% AGI floor.

**Title issues or disputes.** Legal costs related to the acquisition of property or to the determination of title to property, whether such property is business or personal, are nondeductible capital expenditures. They are added to the basis of the property. For example, litigation costs to fix the value of shares of dissident shareholders are not deductible because they are related to the purchase of the stock and are part of the cost of acquisition.

Legal fees incurred to acquire title to stock were also held to be nondeductible.

Where a dispute over property does not involve title, such as in a recovery of income-producing securities loaned as collateral, the Tax Court holds that legal fees are deductible.

**Personal injury or marital actions.** Where you recover taxable damages, you may deduct the legal fees. If the damages are not taxable, legal fees are not deductible; see ¶12.10. For legal expenses incurred in marital actions, see ¶37.8.

**Collecting Social Security.** If you hire an attorney to press a claim for disputed benefits, such as disability benefits, you may deduct the legal fees only to the extent that your benefits are taxable under the rules of ¶34.3. For example, if 50% of your Social Security benefits are taxable, 50% of your legal fees are treated as miscellaneous expenses subject to the 2% AGI floor.

**Estate tax planning fee.** All or part of an attorney's fee for estate tax planning services may be deductible. Estate tax planning usually involves tax and non-tax matters. To the extent that the services do not cover tax advice or income-producing property, the fee is not deductible. A bill allocating a fee between deductible and nondeductible services may help support a deduction claimed for the deductible portion of the fee.

**Recovery of attorneys' fees from government;** see Chapter 47.

